Office of Chief Counsel
Internal Revenue Service

memorandum

CC:NER:OHI:CIN:TL-N-4452-99
LRAverbeck

date:

to: Chief, Examination Division, Ohio District
Attn: Diane Camper

from: District Counsel, Ohio District

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subject: [redacted]
Request for Advisory Opinion

This responds to your request for assistance in regard to issues arising from [redacted]'s payment of lawsuit damages.

ISSUES

1. What portion of the settlement payment made by [redacted] is deductible as ordinary and necessary business expenses? What portion is attributable to a fine or penalty and therefore nondeductible?

2. Can the entire allowable deduction be taken by [redacted] in [redacted], including the amount of the settlement agreed to in [redacted]?

3. Is [redacted] entitled to a refund of tax paid on the overcharged amounts in earlier years under the Claim of Right doctrine?

CONCLUSION

1. [redacted] may deduct that portion of the settlement amounts which represents the amount of the government's actual losses due to the overcharges. In addition, [redacted] may deduct that portion of the settlement amount which it can show was intended to compensate the government for additional losses due to the overcharges, such as interest. [redacted] may not deduct the portion which was paid to settle claims for fines or penalties. Although more information is needed to determine the exact amounts which are deductible and those which are not, allowance of a portion based on the currently available

information would be appropriate.

2. [redacted] may not deduct in [redacted] the amount paid in [redacted]. The eight and one-half month exception to section 461 of the Internal Revenue Code does not apply in this situation.

3. [redacted] may either deduct the amount of overcharges which were repaid or offset its tax liability for the year of repayment by the amount of taxes attributable to the overcharges from the years those amounts were included in income, whichever option yields a lower tax liability.

FACTS

The taxpayer, [redacted], is the successor, through a series of corporate acquisitions and mergers, of [redacted] and [redacted]. These companies all sold products to the United States Department of Defense ("DoD"). [redacted], while a subsidiary of [redacted], entered into prime contracts with the Department of Defense and also into subcontracts with prime contractors. After a DoD audit, the Government filed suit in [redacted] against [redacted] and the predecessor companies, alleging illegal overcharges on [redacted] sales contracts. The suit eventually stated a number of theories for recovery, including violations of the False Claims Act and common law theories such as fraud, negligence, mistake of fact, unjust enrichment, and breach of contract. Originally, the Government alleged actual overcharges of $[redacted] on "prime contracts" and later added allegations of overcharges through "upper tier suppliers" of $[redacted]. The suit also sought treble damages under the False Claims Act, as well as interest.

In [redacted], a partial settlement of the suit, covering [redacted] of the contracts, was reached. Under this partial settlement, [redacted] agreed to pay the Government $[redacted]. In [redacted], the suit was settled as to the remaining contract, with [redacted] agreeing to pay $[redacted] more. Neither settlement agreement allocated the payments between actual damages, treble damages, and interest. Neither allocated actual damages between the prime contracts and the upper tier damages, although one provision of the settlement specifically says that the parties' intent was "to relieve [redacted] from liability for upper-tier damages."

The taxpayer deducted all of the $[redacted] called for by the settlements on its [redacted] Federal income tax return. *Apparently, the taxpayer recognizes that treble damages are not* deductible, but has contended that the entire settlement is deductible because interest alone on the amount the Government sought in the suit exceeds the amount of the settlements. It also apparently recognizes that deduction of the [redacted] settlement on the [redacted] return is problematic. Thus, the taxpayer contends that the "eight and one-half month rule" of Treas. Reg. § 1.461-5 applies to allow the deduction. In addition, the taxpayer contends it is entitled to relief under I.R.C. § 1341(a) ("restoration of a substantial amount held under a claim of right").

The Revenue Agent has concluded that only a portion of each settlement payment ($[redacted] for [redacted] and $[redacted] for [redacted]) is deductible, and that each portion deductible may be deducted only in the year paid. She agrees that some relief (which she computes to be $[redacted]) is available under section 1341.

DISCUSSION

Issue 1: Section 162(a) of the Internal Revenue Code allows a deduction of "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." Section 162(f), however, states that "[n]o deduction shall be allowed under subsection (a) for any fine or similar penalty paid to a government for the violation of any law." Section 1.162-21(b)(1) of the Treasury Regulations defines fine or similar penalty to include, among other things, an amount paid as a civil penalty imposed by Federal, State, or local law, including additions to tax, or as an amount paid in settlement of the taxpayer's actual or potential liability for a fine or penalty (civil or criminal). Section 1.162-21(b)(2) provides, however, that compensatory damages paid to the government do not constitute a fine or penalty.

Whether payment of a fine or penalty is deductible depends on the purpose the fine or penalty was meant to serve. If a civil penalty is imposed for purposes of enforcing the law and as punishment for violation of the law, it is not deductible. Talley Industries, Inc. v. Commissioner, 116 F.3d 382, 385-86 (9th Cir. 1997)(citing Southern Pac. Trans. Co. v. Commissioner, 75 T.C. 497, 653 (1980)). If the civil penalty is imposed to encourage prompt compliance with a requirement of the law, or as a remedial measure to compensate another party for expenses incurred as a result of the violation, it is deductible because it does not serve the same purpose as a criminal fine and is not "similar" to a fine within the meaning of section 162(f). Id.

The amount which [redacted] paid to the government in compensation for the government's actual losses due to the overcharges, as well as damages paid to compensate the government for other expenses due to the overcharges, are deductible expenses. The amounts which [redacted] paid the government in settlement of potential liability for fines or penalties, including the treble damages provision of the False Claims Act, are not deductible expenses. Unfortunately, the settlement agreement between the United States and [redacted] made no allocation of the settlement amounts between compensatory damages and fines or penalties. When this is the case the courts will consider the circumstances surrounding the agreement to determine the intent of the parties regarding the nature of the payments. Was the settlement which exceeded the actual amount of overcharges intended to relieve [redacted] of the penalties including treble damages it may have been liable for under the False Claims Act, or to compensate the government for the time and expenses incurred as a result of the violation?

The Talley Industries cases involved a similar situation and provide some guidance for the present case. In Talley Industries, Inc. v. Commissioner, T.C. Memo 1994-608, rev'd and rem'd, 116 F.3d 382 (9th Cir. 1997), the taxpayer, like [redacted], faced liabilities under the False Claims Act consisting of a $2,000.00 penalty, an amount equal to two times the government's actual damages and the costs of the civil action, which amounts were in excess of the government's actual losses. The amount of the taxpayer's settlement with the government exceeded the government's actual damages by $940,000.00. The court noted that the double damages provision of the False Claims Act (which has since been amended to provide for treble damages) has both compensatory and deterrence purposes. Talley Industries, Inc. v. Commissioner, 116 F.3d 382, 387 (9th Cir. 1997). The parties disagreed as to what purpose the excess amount was meant to serve. Id. The court found it necessary to look to extrinsic evidence such as the negotiations and proposals between the two parties which led up to the final settlement agreement in order to determine whether the parties intended the settlement to encompass penalties for the purpose of punishment and deterrence, as the government asserted, or compensation for unknown costs, as the taxpayer claimed. It is not determinative that the contested portion of the settlement is not equal to double the amount of actual damages. Id. The parties may have settled the claim for less than the maximum amount the government could have received at trial.

In finding that the amount of the settlement in excess of actual damages was not deductible, the Ninth Circuit Court of Appeals relied upon, among other things, a letter that an attorney for Talley Industries wrote during negotiations in which he expressed concern that Talley be released from all possible liabilities relating to the overcharging including the double damages provided for in the False Claims Act. Id. In addition, both parties arrived at their respective settlement figures by doubling their estimate of the government's actual damages, thus acknowledging that Talley was liable for the double damages provided for in the False Claims Act. See id. The District Court also relied upon the petitioner's failure to meet its burden of showing entitlement to the deduction it claimed. Id.

The court in the Talley Industries cases found that the Tax Court erred in assuming the government was required to characterize the payment. It is the taxpayer's burden to demonstrate entitlement to a particular deduction. Talley Industries, Inc. v. Commissioner of Internal Revenue, 116 F.3d 382, 387-88 (9th Cir. 1997)(citing Norgaard v. Commissioner, 939 F.2d 874, 877 (9th Cir. 1991)). Thus, in your case, in order to deduct the entire settlement payments, [redacted] must show that the parties intended the entire amount of the settlements to represent compensation to the Government for its losses. As in Talley Industries, it is likely that [redacted] and the government intended for the settlement to encompass all possible claims against [redacted], including the punitive damages portion of the treble damages provision of the False Claims Act, which amounts would not be deductible.

[redacted] asserts that since the interest amounts which the government sought to recover in addition to the losses from the overcharges would amount to more than the amount of the settlement, the entire settlement amount should be deductible. (No authority for this position was indicated in the memo.) In Talley Ind. v. Commissioner, T.C. Memo 1999-200, the Tax Court rejected a similar argument:

> We reject petitioner's contention that the disputed portion of the settlement agreement cannot be considered a penalty because the Government's actual losses purportedly exceeded the entire $2.5 million settlement payment. Neither party made a serious effort to quantify the Government's actual losses in excess of its "singles" damages of $1.56 million.

77 T.C.M. (CCH) 2191, 2196 (1999).

In our view [redacted] is entitled to deduct that portion of each settlement which is equal to the government's actual losses due to the overcharging and interest on those amounts.

The Revenue Agent has tentatively determined (apparently based on ratios derived from the amounts claimed and the amounts agreed upon in settlement) that the allowable amounts are $[redacted] for [redacted] and $[redacted] for [redacted]. We think that the approach taken by the Revenue Agent, to allow a portion rather than deny the entire deduction outright for lack of substantiation, is reasonable. However, we suggest that the computations of the amounts allowed, and the explanations for these computations, be fully documented in the agent's work papers, if not in the Notice of Proposed Adjustment or the Revenue Agent's Report themselves.

Further, we suggest that if the information available to the agent provides any basis for considering part of the settlement payments as interest, that additional reasonable estimates of interest be made and allowed also. Whether or not any additional settlement amount is deductible cannot be determined without more information. Since the total settlement amounts were far in excess of alleged actual damages from the overcharges, and the settlement agreements state that they cover all claims for costs, interest and damages, it is reasonable to assume that the government and the taxpayer intended some portion of the settlements to represent a compromise of potential fines or penalties. Otherwise, the agreements would be incomplete. The settlement agreements do clearly state that they were intended to relieve [redacted] of all upper-tier damages. We have little information on these.

Ideally, the agent should review the negotiations and offers relating to the settlement to determine the intent of the parties as to the nature of the excess settlement amounts. Only with information of that sort can a final determination be made. In the meantime, a partial allowance is appropriate.

Issue 2: Section 461 of the Internal Revenue Code gives the rule for determining the taxable year in which a deduction may be claimed. [redacted] is claiming a deduction on its [redacted] return for the entire amounts of settlements accomplished in both [redacted] and [redacted]. Its claimed authority is section 461(h)(3)(A)(ii)(II) (the "recurring item" exception for economic performance within eight and one-half months of the close of the taxable year).

This exception does not apply to the present situation. Section 1.461-5(b) of the Treasury Regulations states that under the recurring item exception, a liability is treated as incurred for a taxable year if all events that establish the fact and amount of the liability have occurred by the end of the taxable year, economic performance has timely occurred, and the liability is recurring in nature. In [redacted]'s case, neither the all events test nor the recurring liability element is met. The amount of the settlement reached in [redacted] was not even known much less paid until [redacted]. So the all events element is not met. In addition, it is clear this liability is not "recurring" for purposes of this rule. Section 1.461-5(b)(3) states that a "liability is recurring if it can generally be expected to be incurred from one taxable year to the next." Section 1.461-5(c) specifically states that the recurring item exception does not apply to any liability of a taxpayer incurred under tort, breach of contract or violation of law. Thus, the eight and one-half month exception to section 461 does not apply here, and [redacted] may not deduct in [redacted] any of the [redacted] settlement amount.

Issue 3: Section 1341 of the Internal Revenue Code provides for either a deduction or a reduction in tax when restitution is made of an amount which was included in taxable income in a previous taxable year under a claim of right. Specifically, the Internal Revenue Code provides for an adjustment of income tax where an item was included in gross income in a prior taxable year or years because it appeared that the taxpayer had an unrestricted right to such item and a deduction of more than $3,000.00 is allowable for the taxable year because it was later established that the taxpayer did not have an unrestricted right to such item. In such a situation, the taxpayer may compute tax for the year of repayment by taking the deduction or he may reduce his tax in the repayment year by the amount of tax for the previous years which was attributable to the inclusion of the repaid amount, whichever option yields a lower tax liability. Either way, the adjustment is made in the year of repayment. The taxpayer cannot claim both a refund and a deduction. The return for the earlier year remains closed. See Treas. Reg. § 1.1341-1 (as amended in 1996).

Once the amount of the allowable deduction has been determined, [redacted] may either take the deduction in [redacted] and [redacted] and compute its tax with the entire deduction, or compute the tax for [redacted] and [redacted] without the deduction, and subtract from its tax liability the amount of tax from earlier years that was attributable to the overcharges in those years. It will be necessary to determine the exact amount of the overcharges in the earlier years, because only the tax attributable to those amounts may be subtracted. Section 1341 of the Internal Revenue Code does not allow for both a refund of tax paid in earlier years and a deduction of amounts repaid later.

However, no deduction under Section 1341 is allowed where the repaid amounts were illegally or wrongfully obtained, such as through fraud or embezzlement or any receipt of earnings which the taxpayer knew he did not have a legal right to claim. In such a situation, the funds were not received under a claim of right. The government's complaints alleged fraud. If [redacted] intentionally overcharged the government on the contracts and knew that it did not have a legal right to funds obtained, the adjustment provided under Section 1341 cannot be claimed. We do not have sufficient information at this time to conclude whether the adjustment under the Claim of Right may be applied. It would be difficult to prove that the overcharges were intentional and fraudulent and that [redacted] therefore had no claim of right to the amounts now being deducted.

If you have any questions, please contact Attorney Linda R. Averbeck at (513)684-3211.

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By: ______________________
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